



# **Legislative Audit Division**

State of Montana

Report to the Legislature

August 2003

## **Limited Scope Performance Audit**

### **Tax Dispute Resolution Process for Corporate License and Natural Resource Taxes**

Compliance, Valuation and Resolution Division  
Department of Revenue

This audit report concludes on the process used by the Department of Revenue to resolve taxpayer disputes over corporate license and natural resource tax liability. We found the process ensures uniform and fair treatment of taxpayers.

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Members of the performance audit staff hold degrees in disciplines appropriate to the audit process. Areas of expertise include business and public administration, statistics, economics, political science, criminal justice, logistics, computer science, and engineering.

Performance audits are performed at the request of the Legislative Audit Committee which is a bicameral and bipartisan standing committee of the Montana Legislature. The committee consists of six members of the Senate and six members of the House of Representatives.

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# LEGISLATIVE AUDIT DIVISION

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August 2003

The Legislative Audit Committee  
of the Montana State Legislature:

This is our limited scope performance audit of the process used for resolving disputes related to corporate license and natural resource taxes. The Compliance, Valuation and Resolution Division administers the majority of this process. The Office of Dispute Resolution also participates in the tax dispute resolution process through its mediation services. Both of these functions are part of Department of Revenue responsibilities. We found the process ensures uniform and fair treatment of taxpayers.

We wish to express our appreciation to Department of Revenue personnel for their cooperation and assistance.

Respectfully submitted,

*(Signature on File)*

Scott A. Seacat  
Legislative Auditor



# **Legislative Audit Division**

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## **Limited Scope Performance Audit**

### **Tax Dispute Resolution Process for Corporate License and Natural Resource Taxes**

**Compliance, Valuation and Resolution Division  
Department of Revenue**

Members of the audit staff involved in this audit were Lisa Blanford and Mike Wingard.



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## **Appointed and Administrative Officials**

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### **Department of Revenue**

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Don Hoffman, District 1 Lead  
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Gene Walborn, Region 7 Lead  
Compliance, Valuation and Resolution Division

Howard Heffelfinger, Dispute Resolution Officer  
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### Introduction

The Department of Revenue administers Montana's tax laws and serves as the general tax collection agency. Revenue collection responsibilities include appraising values of taxable property, assessing tax liability, and auditing for taxpayer compliance. Each of these department functions can generate taxpayer disagreement. Thus, there must be a process to allow taxpayers to receive full explanation of assessments, bring forth concerns, present additional facts for consideration, and resolve disputes between taxpayers and the department. The Legislature provided a process to protect taxpayers by enacting the Taxpayer Bill of Rights and requiring the Department of Revenue to provide for a uniform dispute resolution procedure.

The Legislative Audit Committee requested a performance audit of the tax dispute resolution process followed by the Department of Revenue. The Committee expressed interest in the process as it pertains to Corporate License and Natural Resource taxes.

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### Background

Assessments from compliance audits of businesses liable for corporate license or natural resource taxes are typically the "trigger point" for taxpayer disputes. Taxpayers can appeal department tax assessment decisions. The appeal process starts as an informal appeal directly to audit staff and management. If the dispute cannot be resolved, either the taxpayer or department may refer the dispute to the department's Office of Dispute Resolution, which offers mediation of tax issues. If parties to the tax dispute cannot resolve issues via administrative remedies, disputes progress to a more formal course of appeal. Appeals can be brought before the State Tax Appeal Board and finally the judicial system. Resolution may occur at any level of the process. The department emphasizes resolving tax disputes as early as possible through the department's informal administrative review process.

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### Results in Brief: Dispute Resolution Process Provides for Uniform and Fair Treatment

Our review and testing shows the dispute resolution process related to corporate license and natural resource tax assessments is designed to provide multiple opportunities for either party to a tax dispute to discuss issues relating to the assessment, bring forth arguments, and

## Report Summary

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resolve disputes. The process treats both parties to a dispute fairly by providing for independent and objective review of facts and issues and including several levels of appeal. Availability of the Office of Dispute Resolution, the State Tax Appeal Board, and the court system guarantees independent consideration of issues. The dispute resolution process is designed to ensure fair and consistent treatment of all parties as a result of a tax dispute regardless of tax type or other issues.

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### Principal Findings

The principal findings and conclusions of this audit are:

- ▶ Department of Revenue's corporate license and natural resource tax assessments are generally not reduced during the protest and appeal process. Audit assessments issued by the department are usually upheld.
- ▶ The majority of corporate license and natural resource tax disputes are resolved during the administrative review portion of the process and rarely progress on to appeals before the State Tax Appeal Board or the court system.
- ▶ Accounting and taxation principles – technical issues as opposed to interpretation of law - are the most common reasons cited during a tax dispute.
- ▶ The Department of Revenue established an effective system of controls over the administrative remedy portion of the tax dispute resolution process for corporate license and natural resource taxes.

Our review and testing shows the process provided for in statute to protect taxpayers through the Taxpayer Bill of Rights and requiring the Department of Revenue to provide for a uniform dispute review procedure is in place and functioning as intended. As a result, this audit makes no recommendations for improvement.

# Chapter I - Introduction

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## Introduction

The Department of Revenue (DOR) administers Montana's tax laws and serves as the general tax collection agency. Revenue collection responsibilities necessitate appraising values of taxable property, assessing tax liability and taxes due, and auditing for taxpayer compliance. Each of these department functions can generate taxpayer disagreement with tax liability assessed by the department. Thus, there must be a mechanism or process in place to allow taxpayers to:

- ▶ Receive full explanation of tax assessments generated by the department.
- ▶ Bring forth concerns.
- ▶ Present additional facts for consideration.
- ▶ Challenge department tax assessments.
- ▶ Resolve disputes between the taxpayer and DOR.

The Legislature provided a process to protect taxpayers by enacting the Taxpayer Bill of Rights and requiring the Department of Revenue to provide for a uniform dispute review procedure. This process is commonly referred to as the "dispute resolution process."

The Legislative Audit Committee requested a limited scope performance audit of the tax dispute resolution process followed by the Department of Revenue. The Committee expressed interest in the dispute resolution process as it pertains to Corporate License and Natural Resource Taxes.

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## Audit Objectives

The performance audit objectives were to:

1. Determine how the department's compliance audit process for corporate license and natural resource taxes works and how entities are selected for compliance audits.
2. Examine the department's dispute resolution process related to corporate license and natural resource taxes to determine uniformity and fairness of the process.

## Chapter I - Introduction

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### **Audit Scope and Methodologies**

The scope of this audit centered on the dispute resolution process as it pertains to assessment of corporate license and natural resource taxes. Our focus was on examining aspects of the process related to dispute resolution, not the department's auditing techniques or quality of the audit process. The period of review was July 1, 2000 through February 28, 2003. We examined department compliance audit files and related dispute resolution documentation for 56 corporate and 22 natural resource entities.

In order to gain an understanding of the process and develop criteria for the audit, we reviewed statutes, administrative rules, and department policies and procedures. We identified general tax administration responsibilities of the department, taxpayer rights, and dispute resolution requirements. We contacted other states and the U.S. Department of the Treasury, Internal Revenue Service to determine how their tax dispute resolution process works for comparative purposes. Program information and statistics were obtained and examined. We interviewed department personnel responsible for, or involved with, tax assessments and taxpayer disputes. We also obtained input and gathered documentation from the department's Office of Legal Affairs and Office of Dispute Resolution. We contacted the State Tax Appeal Board to obtain input from board members and obtained and reviewed relevant data and documents.

We concentrated our efforts on the portion of the department's Compliance, Valuation, and Resolution Division responsible for administering audits of and resolving tax disputes with entities required to pay corporate license tax and natural resource taxes. This was done in order to gain a thorough understanding of the dispute resolution process. In addition to interviewing a number of staff, we examined related policies and procedures and other guidelines used to direct their work. We familiarized ourselves with resources used by division audit staff including automated data processing systems, desk and field audit selection criteria, and federal revenue reports. We observed staff conducting office-based audit work. We

discussed field audit methodology and procedures used with audit staff. We specifically examined:

- ▶ Working papers gathered during audits to gain an understanding of the type of work involved and extent of documentation.
- ▶ The department's audit records and management reports for evidence of taxpayer disputes and methods used to resolve disputed tax issues.

We reviewed and analyzed those instances where taxpayers contacted the department to register disagreement, or dispute, with an assessment. We reviewed documents and discussed these cases with department staff in order to determine the process followed to resolve taxpayer concerns or disputes. We examined records to compare and conclude on whether:

- ▶ Processes followed to resolve individual tax disputes adhere to requirements in statute and administrative rule.
- ▶ Department management is notified of disputes and approves key documents such as tax assessments and final tax due assessments.
- ▶ Taxpayers are notified of the right to appeal and instructed on the appeal process.
- ▶ Parties to a tax dispute are fairly treated.

We observed conferences between department representatives and taxpayers that are conducted as a means of resolving tax disputes. We analyzed department tax assessments and compiled statistics comparing original department tax assessments against final assessments to determine how often assessments are revised due to taxpayer disputes, and subsequent agreement to settle a disputed matter. We used this data to determine if there is uniformity and fairness in the process.

The department is responsible for delinquent account collection and enforcement activities. Part of the bad debt collection process involves negotiations between the department and taxpayers

## **Chapter I - Introduction**

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regarding resolution of outstanding tax debt. We did not include negotiations involved with bad debt collection activities in our audit scope. The audit focused on resolution of disputes stemming from tax assessments rather than collection activities.



# Chapter II - Background

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## Introduction

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The tax dispute resolution process involves a number of different processes both within and outside the Department of Revenue. Assessments from compliance audits are the “trigger point” for taxpayer disputes and taxpayers can appeal department tax assessment decisions. The appeal process starts as an informal appeal directly to audit staff and management. If the dispute cannot be resolved, either the taxpayer or department may refer the dispute to the department’s Office of Dispute Resolution, which offers mediation of tax issues being disputed. The dispute can then follow a more formal course of appeal, which includes the State Tax Appeal Board and finally the judicial system. Resolution may occur at any level of the process.

This chapter provides general information on the Department of Revenue, background regarding corporate license and natural resource taxes, and describes the department’s audit function as it pertains to these taxes. A detailed discussion of the tax dispute resolution process then follows.

## Department of Revenue

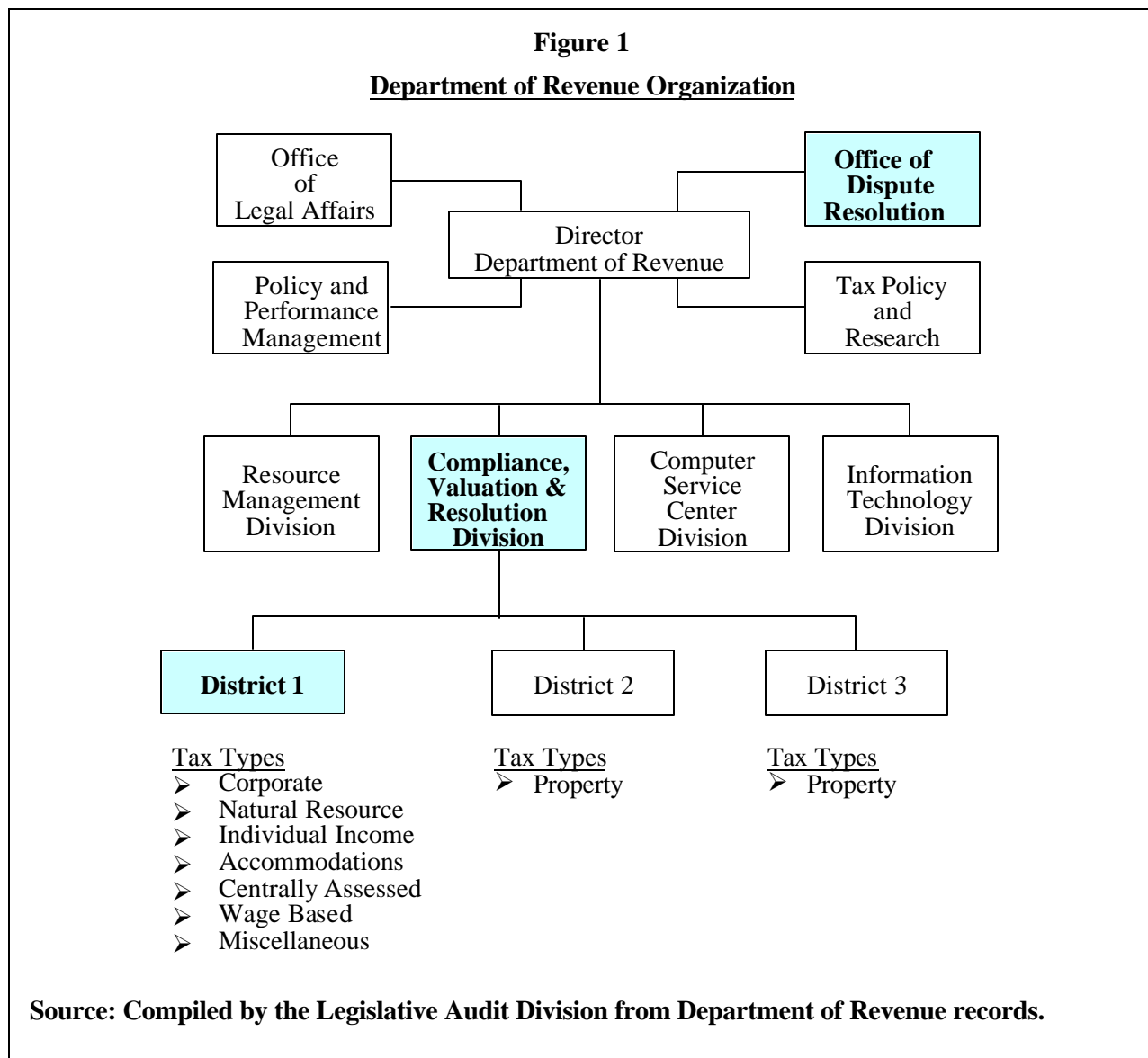
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The Department of Revenue collects revenue from and enforces regulations for over 30 state taxes and fees. The department is organized into five core processes with overall agency direction and management coordinated from the Director’s Office. The Director’s office includes the Office of Dispute Resolution, which reviews, facilitates, and resolves taxpayer disputes.

The Compliance, Valuation and Resolution (CVR) Division conducts audits in order to verify taxpaying entities are in compliance with tax law. The program is also responsible for valuation of properties statewide for purposes of property taxation. The CVR division is divided into three districts. District 1 is responsible for corporate, natural resource, individual income, accommodations, wage based, and miscellaneous taxes. District 1 staff is also responsible for centrally assessed property appraisals that include industrial, utility, and railroad property. Districts 2 and 3 focus primarily on residential, agricultural, and business property appraisals and taxation. The following figure shows organizational

## Chapter II - Background

structure of the Department of Revenue and highlights the Office of Dispute Resolution and CVR Division.



### Corporate License Tax

Montana's corporate license tax is an income tax levied on corporations conducting business in the state. The license tax was enacted in 1917 making it one of the oldest taxes. The tax is levied at the rate of 6.75 percent on net income received from all sources within the state of Montana. Corporations choosing a "water's edge"

election (an election which allows the taxpayer to exclude subsidiaries that operate outside the United States) pay a 7 percent tax on net income received in Montana. Corporations whose only activity in Montana consists of making sales, and who do not own or rent real estate or tangible personal property, and whose annual gross income from sales in the state does not exceed \$100,000 may elect to pay a tax equal to  $\frac{1}{2}$  of 1 percent of gross sales. The minimum tax required by any corporation is \$50. However, if a corporation has no property, payroll, or sales in Montana during the tax period, it is not subject to the minimum tax.

All corporations doing business in Montana must file an annual corporate tax return. Corporations electing to file as a subchapter S-corporation for federal income tax purposes must also file as an S-corporation for Montana tax purposes. S-corporations are not subject to the corporate license tax; instead, the income of these corporations flows through to individual shareholders and is subject to the state's individual income tax. The following table provides information on the number of corporate tax returns filed between July 1, 2001 and June 30, 2002.

**Table 1**  
**Corporate Tax Returns Filed**  
**July 1, 2001 through June 30, 2002**

S-Corporations	16,401
Regular Corporations	16,689
<b>Total Corporations</b>	<b>33,090</b>
Corporations Paying \$50 Minimum Tax	9,740
Corporations Paying More Than \$50 Tax	6,152
Corporations Paying No Tax	797
<b>Total Regular Corporations</b>	<b>16,689</b>

**Source: Compiled by the Legislative Audit Division from Department of Revenue records.**

## Chapter II - Background

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Under current law, 100 percent of corporate license taxes are deposited in the state General Fund. The statute of limitations for the corporate license tax is three years. According to data compiled by the department, approximately 100 corporations pay 60 percent of Corporate License Tax Collections. Corporate License Tax collections are shown in the following table.

**Table 2**  
**Corporate License Tax Collections**  
**Fiscal Years 1996 through 2002**

FY 1996	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
\$75,761,891	\$81,999,138	\$77,928,498	\$89,624,559	\$99,088,870	\$103,670,487	\$68,173,254

**Source: Compiled by the Legislative Audit Division from Department of Revenue records.**

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### Natural Resource Taxes

Natural resource taxes include coal severance, coal gross proceeds, oil and natural gas production, metalliferous mines license, metal mines gross proceeds, miscellaneous mines net proceeds, resource indemnity and groundwater assessment, electrical energy production, and cement and gypsum. Taxes are based upon production, value of product, gross or net proceeds - depending on the natural resource and type of tax. Tax rates vary widely depending upon the type of tax. The following table provides the number of natural resource taxpayers in Montana during fiscal year 2002.

**Table 3**  
**Natural Resource Taxpayers**  
**Fiscal Year 2002**

Coal Severance Tax	5
Coal Gross Proceeds	5
Oil and Gas Production Tax	250
Mining License Tax	4
Metal Mines Gross Proceeds Tax	4
Mines Net Proceeds Tax	5
<b>Total</b>	<b>273</b>

**Source: Compiled by the Legislative Audit Division from Department of Revenue records.**

The Department of Revenue has the statutory responsibility and authority to collect natural resource taxes and distribute proceeds. There is a five-year statute of limitations on natural resource taxes. Natural resource taxes are filed on a quarterly basis. Proceeds from natural resource taxes are distributed to the state and local governments. The following table illustrates the state's share of natural resource tax collections.

**Table 4**  
**State Share of Natural Resource Tax Collections**  
**Fiscal Years 1996 through 2002**

<b>FY 1996</b>	<b>FY 1997</b>	<b>FY 1998</b>	<b>FY 1999</b>	<b>FY 2000</b>	<b>FY 2001</b>	<b>FY 2002</b>
\$60,208,207	\$59,738,719	\$51,587,343	\$52,962,852	\$67,180,552	\$70,730,347	\$54,416,565

**Source: Compiled by the Legislative Audit Division from Department of Revenue records.**

### **Department Compliance Audits**

The Department of Revenue is responsible for ensuring compliance with the tax-related provisions of statute. This is done through a

## Chapter II - Background

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variety of monitoring methods including audits and investigations that examine compliance with the state's tax laws and verify correct payment of tax liability. Helena-based staff within the department's Compliance, Valuation and Resolution Division is responsible for reviews of corporate license and natural resource tax returns and related records. The department employs audit staff that specializes in each of these two tax types. In addition, the department contracts with the U.S. Department of the Interior to perform federal mineral royalty audits. The following table shows the number of staff performing compliance audits for corporate, natural resource, and federal mineral royalty taxes.

**Table 5**  
**Compliance Audit Actual FTE**  
**Corporate and Natural Resource Taxes**  
**Fiscal Years 1996 through 2002**

<b>Tax Type</b>	<b>FY 1996</b>	<b>FY 1997</b>	<b>FY 1998</b>	<b>FY 1999</b>	<b>FY 2000</b>	<b>FY 2001</b>	<b>FY 2002</b>
Corporate License	14.00	12.85	10.11	7.73	10.80	7.53	11.88
Natural Resource	5.00	3.04	3.02	3.65	3.74	5.00	5.00
Federal Royalty	<u>2.73</u>	<u>2.94</u>	<u>1.76</u>	<u>2.74</u>	<u>2.52</u>	<u>1.00</u>	<u>1.18</u>
<b>Total FTE</b>	21.73	18.83	14.89	14.12	17.06	13.53	18.06

**Source: Compiled by the Legislative Audit Division from Department of Revenue records.**

The department conducts two different types of audits that vary in level of review. A less detailed level of audit is conducted in the central Helena office and is referred to as an office audit. A field audit is a much more detailed review and includes visits to a corporation. While office audits focus primarily on information reported on and provided with a tax return, field audits expand this focus and incorporate business records and detailed financial data into the audit.

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### **Compliance Audit Selection Criteria**

The department has established a number of parameters and indicators for selecting corporations and natural resource companies

for audit review. These potential audit indicators have been developed over time based upon the experiences of the department, other states, and the federal government. Department staff relies on a number of selection methodologies including:

- ▶ Computer-generated audit candidates.
- ▶ Internal Revenue Service reports.
- ▶ Past history of an entity complying with tax law.
- ▶ Length of time since a company was last audited.
- ▶ Level or amount of production activity.
- ▶ Amount of income.
- ▶ Requests from local governments.
- ▶ Taxpayer tips.

In addition, audit staff considers the potential level of non-compliance, projected potential outstanding tax liability, and cost-effectiveness of conducting a full on-site compliance audit.

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### Office Compliance Audits

In fiscal year 2002, the department completed office audits of 60 of the approximately 270 natural resource companies filing a tax return in the state. Department staff also examined approximately 17,000 individual corporate license tax returns through its office audit function. (The number of returns examined includes any prior year returns queried during an examination of a current year return.) During an office audit, tax returns are reviewed without examination of all underlying records and verification of all information. For example, audit staff will reconcile state and federal taxable income, ensure tax credits are correctly applied, make sure all required supporting tax schedules are included with the tax return, or check the allocation of non-business income. The department may request the taxpayer provide additional information or records for the tax year in question. Since office audits involve a smaller scope of review, they do not require a team audit approach and individual staff perform the audit work. On average, a typical office audit takes from 30 minutes to one hour to complete depending on complexity of issues and findings.

## **Chapter II - Background**

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### **Field Compliance Audits**

Department staff completed field audits of 19 natural resource companies and 17 corporations filing corporate license returns during fiscal year 2002. A field audit involves a much more detailed level of examination and includes pre-audit research, an on-site assessment of taxpayer records, post-visit analysis and compilation of records, and generation of an audit assessment notice.

Department personnel are typically on-site at a corporation from three to ten days. Field audits are multi-year audits, usually covering three to five tax periods. Typical issues department staff may examine during a field audit include determining the extent of business activities a multi-state corporation conducts within Montana; reviewing apportionment factors including property, payroll and sales; or, examining the source of all deductions and the reasons for the deductions. Since field audits involve more work, they generally require a staff of two. Due to the volume of records examined and the broader scope of reviewing three to five tax years, a typical field audit involves anywhere from 10 to 12 weeks to complete. A field audit of a large corporation with multi-state or international operations generally involves 15 to 18 weeks of staff time to complete.

### **Multistate Tax Commission Audits**

Another resource the department uses, as part of its audit function is information from Multistate Tax Commission (MTC) audits. The commission is an organization of state governments that works with taxpayers to administer tax laws that apply to multistate and multinational enterprises. It operates a Joint Audit Program as a means of promoting efficiency. During a MTC joint audit, a team of auditors reviews the records of a multistate or multinational taxpayer for a number of individual states during a single audit. Audit information and findings are then provided to each participating state for their use in any tax assessment proceedings.

### **Revenue Collections Due to Compliance Audits**

The following table provides information regarding collections that arise from the department's corporate license and natural resource tax compliance audit functions. Collections from audit represent added tax revenue to the state and are assessed in addition to taxes



## Chapter II - Background

paid by a business entity during quarterly or annual tax filings and payments. Collections result from both office and field-based audits.

**Table 6**  
**Department Compliance Audit Collections**  
**Corporate License and Natural Resource Taxes**

**Fiscal Years 1996 through 2002**

<b>Tax Type</b>	<b>FY 1996</b>	<b>FY 1997</b>	<b>FY 1998</b>	<b>FY 1999</b>	<b>FY 2000</b>	<b>FY 2001</b>	<b>FY 2002</b>
Corporate License	\$5,960,037	\$8,805,617	\$6,206,619	\$6,254,454	\$3,892,839	\$ 9,677,154	\$5,172,751
Natural Resources <sup>1</sup>	\$4,400,653	\$2,010,675	\$5,947,309	\$6,457,801	\$ 643,016	\$38,855,819	\$ 590,950

Footnote:

<sup>1</sup> Revenue spike in FY 2001 due to resolution of a tax dispute.

**Source: Compiled by the Legislative Audit Division from Department of Revenue records.**

### **Department Compliance Audits Can Generate Protests**

If the department's audit activities reveal a taxpayer owes additional taxes, the department sends the taxpayer an assessment notice indicating an additional liability. The department's audit management team reviews all significant assessments and field audit assessment notices before they are sent to a taxpayer. For corporate and natural resource taxes, the department sends written notification (statement of account) to the corporation of a preliminary decision that additional taxes are due. This initial assessment notice contains the rationale supporting the department's decision to assess additional taxes. The initial assessment notice provides the taxpayer with a 30-day period to contact the department to file a protest and request an informal conference concerning the assessment. Department management indicates most taxpayers who receive a tax due assessment contact the department to discuss the assessment. However, not all choose to protest the assessment and request an informal conference. Most pay the assessment after discussion with the department.

## **Chapter II - Background**

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### **Dispute Resolution Process**

For those taxpayers that disagree with an assessment and choose to file a protest, the dispute resolution process provides for two distinct levels of review: administrative review and appeal. This process provides taxpayers an opportunity to discuss tax assessments and provide information demonstrating why they disagree with proposed department assessments. Administrative review involves discussions between the taxpayer and department staff, and can include arbitration with a mediator. If a dispute cannot be resolved to the satisfaction of both parties during the administrative review process, an appeal can be filed with the State Tax Appeal Board and can ultimately involve the judicial system. Administrative remedies are informal proceedings while appeals are formal proceedings. Resolution of tax disputes starts with administrative review and progresses from there. The administrative review process can be bypassed, through stipulation by both parties, but this a rare occurrence.

The department developed a dispute resolution process that applies to the administrative review portions of the process. This portion of the dispute process involves meetings with auditors, informal conferences, and alternative dispute resolution methods, such as arbitration by a mediator. The department emphasizes resolving tax disputes as early as possible through the department's informal administrative review process.

# Chapter III - Findings and Conclusions

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## Introduction

The scope of this performance audit focused on the resolution of tax liability disputes between DOR and corporate license and natural resource taxpayers. Specifically, we examined the processes associated with the resolutions. After collecting and analyzing process information, and reviewing a sample of disputed cases, we formulated conclusions regarding the uniformity and fairness of the tax dispute resolution process. The following sections of the report discuss the dispute resolution process in more detail and present our findings and conclusions.

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## Overall Findings

The majority of taxpayer disputes with corporate license or natural resource taxes are resolved via administrative proceedings, primarily through discussions with audit management and staff, and through informal conferences. A minimal number of corporate license or natural resource tax disputes end up in the appeals process. One of the primary reasons for this involves the basis for the tax dispute. Tax disputes generally involve two distinct areas. One area of dispute involves factual based disputes, which are based on accounting and taxation principles. A factual based dispute for example, would involve oil production numbers in terms of barrels, or whether sales of product were conducted at fair market value. Our audit work shows the department and taxpayers are generally successful at resolving these types of issues without third party intervention.

The other area of tax disputes relates to tax policy and interpretation of law. An example of this is whether a corporation has “sufficient contact” with Montana to allow the state to impose a tax and what constitutes sufficient contact. Disputes related to tax policy and interpretation of law are the cases that tend to involve the court system. These policy issues have the potential for creating a shift in tax policy depending on the outcome of the dispute. These cases can be precedent-setting cases based on judicial interpretation of law.

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## Tax Dispute Resolution Outcomes

Our audit review revealed the majority of initial tax assessments issued by the department due to field audit findings do not change to favor the taxpayer when disputed or protested. Seventy-five percent

## Chapter III - Findings and Conclusions

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of corporate license tax assessments arising from field audits were not reduced during the protest and appeal process. In 25 percent of the corporate cases, the taxpayer successfully challenged the initial assessment.

Seventy-nine percent of assessments resulting from natural resource field audits, either remained the same or were increased during protests; and 21 percent of initial tax assessments were reduced. In general, tax liability was reduced because the taxpayer provided additional information and documents for DOR consideration.

The following table provides several examples of initial assessments levied against corporations as a result of the department's compliance audit function and contrasts the initial assessment to final tax assessment rendered once the dispute was resolved.

**Table 7**  
**Selected Disputed Tax Assessments Resulting from DOR Field Audit Function**  
**Audit Assessment vs. Final Outcome**

**Audit Period of Fiscal Years 2001 through 2003**

	<b># Years Audited</b>	<b>Initial Tax Assessment</b>	<b>Final Tax Assessment</b>	<b>Difference</b>
Corporation A	3	\$ 158,943	\$ 163,224	\$ 4,281
Corporation B	3	\$ 681,502	\$ 681,502	\$ 0
Corporation C	3	\$ 170,477	\$ 115,058	\$ (55,419)
Natural Resource Company A	4	\$ 52,074	\$ 52,074	\$ 0
Natural Resource Company B	4	\$ 33,783	\$ 36,394	\$ 2,611

**Source: Compiled by the Legislative Audit Division from Department of Revenue records.**

The prior table illustrates there are a number of outcomes possible during a tax dispute. There is either no change in the additional tax due, a decreased tax liability or an increased tax liability. Our review indicated the least common outcome is a reduction in tax liability.

## Chapter III - Findings and Conclusions

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**Conclusion:** *Department corporate license and natural resource tax assessments are generally not reduced during the protest and appeal process.*

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### **Administrative Review: Informal Conferences**

Department policy clearly indicates it is the intent of the department to encourage early resolution of tax disputes at the “lowest level” with staff responsible for generating the assessment. Statutes affirm taxpayers have the opportunity to resolve the dispute with the department employee responsible for the assessment notice. Statutes also provide taxpayers with the right to a review by management level employees of the department for additional taxes assessed. The informal conferences offer a number of benefits:

- ▶ Individuals most familiar with the tax issues participate.
- ▶ Opportunity for additional fact gathering.
- ▶ Allows for timely consideration and resolution of protests.
- ▶ Less intimidating for involved parties.
- ▶ Reduces the costs and risks inherent in adjudication or litigation.

Informal conferences include department and taxpayer representatives and are generally conducted via telephone conference. During the conference, rationale and facts supporting the department’s assessment are discussed. The taxpayer can allege audit errors and present any additional facts and arguments supporting the taxpaying entity’s opinion. This provides the taxpayer an opportunity to resolve the dispute with the person(s) responsible for the assessment notice. It provides the department with an opportunity to gather information and consider additional facts. The majority of taxpayer disputes with the department are resolved through informal conferences. During fiscal year 2002, seven corporate license and five natural resource taxpayers invoked their right to an administrative review and requested an informal conference with the department.

After consideration of the facts and arguments presented at the informal conference, department management will issue a final decision and provide the taxpayer with a written final assessment

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notice. If the taxpayer disagrees with the final assessment notice, they can protest the issue further. The taxpayer is allowed 15 days in which to notify the department of intent to appeal. The taxpayer may appeal the department's tax assessment decisions to the Office of Dispute Resolution, the State Tax Appeal Board, or District Court. The Office of Dispute Resolution is generally the next level of appeal in the process although it can be bypassed.

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### Frequency and Nature of Disputes

While the majority of taxed entities who receive a tax assessment contact department audit staff to discuss the assessment, the majority does not file a protest and request an informal conference. In fiscal year 2002, approximately 25 percent of field audit assessments were protested and an informal conference subsequently held. Most of these disputes are resolved at this point, at the lowest level of the dispute resolution process. Informal conferences rely on discussion of issues and facts between the taxpayer and department audit staff. Very few cases are appealed to subsequent levels of the process including the Office of Dispute Resolution, State Tax Appeal Board or the court system. In addition, the majority of disputes involve accounting and taxation principles – technical issues as opposed to interpretation of law. Because of this, most tax disputes will be resolved during the administrative review portion of the dispute process. Those issues related to interpretation of tax law are the issues that end up before the courts for judicial review. In addition, because these types of issues can involve larger sums of money, these are the tax disputes that tend to become public knowledge.

#### *Conclusions:*

- ▶ *The majority of corporate license and natural resource tax disputes are resolved during the administrative review portion of the process and rarely progress on to appeals.*
- ▶ *Accounting and taxation principles are the most common reasons cited during a tax dispute.*

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### Department Process Controls

The department's policy is to encourage early resolution of disputes in order to simplify negotiations and resolve issues in a timely manner. A key aspect of enacting and achieving this goal involves

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the participation of department audit staff early on in the negotiation process. The department instituted controls over disputes and negotiations to ensure fair treatment of taxpayers, responsible actions and decisions by department employees, and adherence to tax law.

We found the department established an effective system of controls over the dispute resolution process. The control system starts with department audit management involvement in the audit selection process. In addition, management is informed of audit outcomes and all tax assessments resulting from audit and compliance activities. Department assessment notices require signature of the lead auditor and a supervisory level staff member. We also found department corporate license and natural resource tax audits are thoroughly documented and the department has a process for reviewing field audit work papers.

In addition, a process is in place for notifying department management when disputes occur or protests are filed. Department policy requires notification of audit management and our review showed staff adheres to this policy. Department management has been historically involved in the resolution process. Audit management participates in the dispute resolution and is directly involved in informal conferences with taxpayers and participates and agrees to any compromises or changes to assessments.

The dispute resolution process is one of negotiation between the taxpayer and department. The department negotiates from a position which considers a number of things including: relative risk, existing case law, strength of the department's issues and opinions, previous experience, and amount and level of documentation available supporting the issue(s). Negotiations are case specific, thus the need for management involvement in the process as a controlling factor. The department is currently strengthening the process by drafting a new policy that requires notification of higher levels of department management depending on the dollar amount of tax in dispute and stage of the process a dispute is at, administrative review or appeal. The dispute resolution process followed by corporate license and

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natural resource audit staff generally follows this draft policy. The policy will eventually apply to all tax types.

**Conclusion:** *The department established an effective system of controls over the corporate license and natural resource tax dispute resolution process.*

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### **Administrative Review: DOR Office of Dispute Resolution**

If a tax dispute cannot be resolved through informal conferences with audit staff, either the taxpayer or department may refer it to DOR's Office of Dispute Resolution (ODR). A key purpose of this added step of administrative review is to offer an alternative to the appeals process. The dispute resolution office was statutorily created in 1999 and is administratively attached to the Director's Office. The office serves as a third party mediator in tax disputes and is designed to foster agreement between opposing parties. Mediators do not have authority to enter a decision on the merits of the issue or impose a decision on the involved parties. Mediation staff do not access tax records as part of the process and there is no pre-determined dollar amount to guide negotiations.

The bulk of cases that come before ODR relate to liquor licensing. Far fewer disputes involving corporate license or natural resource taxes are referred to this office. The following table shows cases pending before ODR during December 2002 and June 2003.



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Table 8

**Cases Pending Before Office of Dispute Resolution**  
**December 2002 and June 2003**

Case Type	Cases Pending	
	December 2002	June 2003
Liquor Licensing	38	56
Individual Income Tax	4	6
<b>Corporate License Tax</b>	<b>1</b>	<b>4</b>
<b>Natural Resource Tax</b>	<b>0</b>	<b>0</b>
Unemployment Insurance	1	2
Accounts Receivable and Collections	1	0
Non-Cash Remunerations to Employees	1	0
Total Cases Pending	46	68

**Source: Compiled by the Legislative Audit Division from Department of Revenue records.**

Parties protesting a tax assessment and seeking assistance by ODR must submit a written request for administrative review along with an explanation of the tax-related issues of dispute. If a decision or resolution has not been attained by the statutory 180-day deadline, the matter is automatically referred to the next level of appeal, the State Tax Appeal Board. Data maintained by ODR reveals during the past three years, three of the four corporate license and natural resource tax disputes referred to this office were resolved through mediation. The fourth case was appealed to the State Tax Appeal Board.

**Conclusion:** *The Office of Dispute Resolution serves its statutory purpose of providing an alternative means of resolving disputes for corporate license or natural resource tax appeals.*

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### Appeals Process: State Tax Appeal Board

A taxpayer dissatisfied with a final decision of the department can appeal to the State Tax Appeal Board (STAB). STAB functions as an independent appeal process for taxpayers. It is not controlled or

## Chapter III - Findings and Conclusions

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supervised by any agency or entity in state government and is organizationally attached to the Department of Administration for administrative purposes only. The board is comprised of three members appointed by the Governor and confirmed by the Montana Senate. The primary function of the state board is to hear tax appeals and issue rulings. The majority of appeals brought before the board relate to property taxes. Few appeals related to corporate license tax or natural resource taxes are filed with STAB. The following table provides a breakdown of appeals pending before the board during November 2002 and May 2003.

**Table 9**  
**Appeals Pending Before**  
**The State Tax Appeal Board**  
**November 2002 and May 2003**

Case Type	Cases Pending	
	November 2002	May 2003
Property Tax	11	15
Property Tax – Centrally Assessed	5	6
Individual Income Tax	1	3
<b>Metal Mines Tax</b>	<b>1</b>	<b>0</b>
<b>Corporate License Tax</b>	<b>2</b>	<b>2</b>
Total Cases Pending	20	26

**Source: Compiled by the Legislative Audit Division from State Tax Appeal Board records.**

A taxpayer can appeal a DOR decision to the STAB by filing a written request with the board. Appeals must be filed within 30 days of notice of the department's final decision on a disputed tax issue and the board must make its final decision within 45 days of receiving the appeal. STAB has authority to uphold, modify, or reverse a DOR decision. The decision of the board is final and binding unless reversed or modified by judicial review.

## Chapter III - Findings and Conclusions

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**Conclusion:** *Independent review before the State Tax Appeal Board provides an additional measure of fairness to the tax dispute resolution process by providing a method of appeal of department decisions.*

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### Appeals Process: Judicial Review

The final alternative in the tax dispute resolution process involves the opportunity for judicial review through the court system. A party to an appeal before the State Tax Appeal Board can petition for judicial review of the board's decision. The petition must be filed at the district court level. In general, cases brought before the courts are debated on the interpretation of tax law as opposed to accounting and taxation principles. Petitions to appeal must be filed and served upon the opposing party within 60 days of the decision of the State Tax Appeal Board. The majority of state tax litigation is the result of an appeal or review of a department determination adverse to a taxpayer. Department management indicates on a yearly average, less than one corporate license or natural resource case is appealed to the court system.

**Conclusion:** *The opportunity to file an appeal for judicial review provides a final avenue of fairness to the tax dispute resolution process.*

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### Uniform and Fair Treatment of Taxpayers

The dispute resolution process is designed to provide multiple opportunities for either party to a tax dispute to discuss issues relating to the assessment, bring forth arguments, and resolve disputes. The process treats both parties to a dispute fairly by including various levels of appeal and providing for independent and objective review of facts and issues. The process steps begin with administrative review designed to facilitate negotiations between the department and the taxpayer. This includes negotiations with department audit staff and when requested, a department mediator. The resolution process also allows for appeals to independent parties including the State Tax Appeal Board and judicial review. Availability of the Office of Dispute Resolution, the State Tax Appeal Board, and the court system guarantees independent consideration of issues. The dispute resolution process ensures

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consistent treatment of all parties as a result of a tax dispute regardless of tax type or other issues.

Our review and testing of the department's compliance audit and related dispute resolution files for 56 corporate license and 22 natural resource taxpayers shows the tax dispute resolution process provides for uniform and fair treatment of taxpayers. Our testing showed:

- ▶ The process as designed in statute and administrative rule provides ample opportunity for discussion and resolution of tax related disputes. We found the department complies with dispute resolution process requirements contained in statute and administrative rules.
- ▶ The department implemented procedures that ensure taxpayers are informed of their right to protest a decision and the steps required. Audit work revealed all DOR assessment notices contain boilerplate language notifying the recipient of the right to protest the assessment and providing instructions. The department's website also provides related information.
- ▶ To ensure timeliness, there are statutory and administrative rule deadlines the department and taxpayer must follow. Audit work revealed these deadlines are adhered to.
- ▶ Taxpayers are treated in a consistent manner with each being afforded the same opportunities for protest and appeal.

The tax dispute resolution process is clear, has been simplified, and consolidated. In addition, we found the department's informal policy is to treat taxpayers on an equal basis by not using department legal counsel unless legal counsel represents the taxpayer.

**Conclusion:** *The dispute resolution process related to corporate license and natural resource taxes provides for uniform and fair treatment of taxpayers.*

# **Department of Revenue Response**

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Linda Francis  
Director

# Montana Department of Revenue



Judy Martz  
Governor

RECEIVED

AUG 27 2003

LEGISLATIVE AUDIT DIV.

August 26, 2003

Jim Pellegrini  
Deputy Legislative Auditor  
Legislative Audit Division  
P.O. Box 201705  
Helena, MT 59620-1705

Dear Mr. Pellegrini:

This letter is in response to your performance audit issued on August 11, 2003 regarding the Tax Dispute Resolution Process for Corporate License and Natural Resource Taxes in the Department of Revenue.

We take great pride in our responsibility of collecting taxes for Montana and it is important to us that we are viewed by the taxpaying public as uniform and fair when we apply tax laws. Your independent review concluded that the business processes we provide to taxpayers are uniform and fair, and you made no recommendations to us for improvement. Your audit was pleasing to me, and it should assure the Legislature and Montana citizens that we are successfully meeting our business requirements, and at the same time, maintaining quality customer service.

Although we have no specific comments related to your audit report, I want to sincerely thank you for the professional way your staff conducted themselves while working at the Department.

Sincerely,

Linda M. Francis  
Director

c: Don Hoffman, Business and Income Taxes Division Administrator  
Gene Walborn, Business Tax and Valuation Bureau Chief